The international banking scene: a supervisory perspective

The Head of Banking Supervision, ***Mr W P Cooke****, addresses*[1] *the question of reconciling a supervisor's concern for sound banking practice with the wider regard a central bank must have for a strong international financial system. He argues that if the present problems are faced with a sturdy realism no significant erosion of prudential standards need occur. But the system must retain the confidence of those who use it, and confidence in itself. Good information flows about markets and risks will help it to make the broadly based judgements that are needed.*

It is with some temerity that a supervisor addresses the topic of the international financial scene. 1982 has been a stirring year by any standards. But maybe it is not a bad time to cultivate a mood in which we may all, with the poet, recollect a little in tranquillity. Let me stand back a little, therefore, as befits a central banker and a supervisor, from the day-to-day preoccupations of the marketplace to see whether the world has really changed all that much during 1982 and how far attitudes, principles and standards need to be modified to fit a changed environment.

The market tends to see issues in stark focus with all the consequent propensity to exaggerate and I would not presume to conclude that 1982 will be seen in retrospect as some kind of watershed. But there have been some events in 1982 which have, like imminent demise, concentrated the mind wonderfully. My main impression of 1982 is not of some overwhelming sense of impending gloom but rather of the beginning of a new realism in facing up to some of the major financial issues.

International banking developments over the past decade . . .

The circumstances of the two oil shocks and their consequences are well worn ground and I do not intend to go over them today. Suffice it to say that the main burden of financing the resultant disequilibrium in international payments fell upon the commercial banks of the world. Partly *faute de mieux*; but they were far from unwilling to take on this task and certainly in the early stages they had considerable capacity to do so without exceeding reasonable prudential bounds. The success in ironing out these imbalances became a cause of some satisfaction, indeed self-congratulation, for bankers demonstrating the robustness and resilience of the international system.

Indeed the commercial bankers made a very real contribution to good order by their actions. In the early 1970s international lending, particularly sovereign lending, was a relatively new field for many banks. There was plenty of room in many portfolios to put on substantial volumes of lending to this relatively new class of borrower within the prudential criteria normally applied for commercial risks. They were rather attractive borrowers too with virtually no record of default and the comfort that they could not follow commercial borrowers into the bankruptcy courts.

But by the end of the 1970s, the authorities in certain countries began to pose some hard questions about the scale of this business, both in respect of individual banks' risk exposure and the consequential debt servicing burden of certain borrowing countries. Furthermore, there was a developing realisation that the rate of growth in international business by the world's major banks which had characterised the 1970s was likely to be unsustainable at the same pace through the 1980s.

On top of this, following the second oil shock, came the strong efforts in a number of major countries to get firmly to grips with the problem of domestic inflation. Strong anti-inflationary policies and high real interest rates added new strains, both domestically and internationally, to set alongside the consequences of a slowdown of activity worldwide in banks' international business. The length and depth of world recession introduced a new element which bankers, and indeed the borrowing countries also, had not taken into account when building up this substantial volume of international indebtedness. So the presumptions, and indeed the reasonable expectations, on which the lending decisions of the 1970s had been originally based—particularly about growth rates and expansion of international business—were significantly different from those which now prevailed.

. . . suggest a reappraisal may be opportune . . .

All these factors have had their impact on the situation of individual banks. The circumstances of the 1970s drew a large number of banks into international lending in the search for good and profitable outlets for the large amounts of liquid funds in the system. Competition was strong and margins tended to erode to levels which did not properly reflect the realities of the risks which had been assumed let alone generate desirable levels of profit. One consequence of these developments, although not wholly arising from banks' international business, has been some downward pressures on capital adequacy levels. This process had reached a point by the beginning of the 1980s where,

(1) In a speech to the Financial Times World Banking conference in London on 9 December 1982.

irrespective of any supervisory admonitions, a number of bankers had concluded that a hard look had become necessary, both of the terms on which lending should be undertaken in the future and of the overall approach to business in the light of a need to contain any further erosion of capital ratios.

So we are in a period of reappraisal. How can we move from where we are to sustain a sound base for international banking business in the rest of the 1980s? It does not seem to be appropriate to represent the present situation as either excessively gloomy or unrealistically euphoric. It may well be a good time indeed for some sturdy realism: problems are often best faced and resolved when they are brought clearly into the open. But there is no overnight cure. Time will be needed for the appropriate adjustments to be made to take account of current and prospective realities. Now is no time for precipitate action or reaction. Bankers should have sensible time horizons: theirs should not be a business which moves impetuously to and from sloughs of despond and the celestial gates.

In coming to terms with these present realities there are many different players who will have to play their part: governments, of both developed and developing countries, international agencies and the banks. The respective contributions to the financing burden by governments and by private sector banks will be one issue, and an important one to which little attention has so far been given. It may be desirable to reconsider the level of concessional flows by governments. The scale of resources available to the IMF and the appropriate degree of conditionality attaching to the use of those resources will be another important factor. Bankers will also need to consider carefully how far they can continue to lend to particular borrowers and on what terms, and their supervisors will need to make their own careful assessment of these decisions. Finally, and not least, some reassessment may be required in some countries of the scale and speed of their development plans, and the extent of their recourse to the world's banking and capital markets.

. . . to ensure a sound footing . . .

As a supervisor, it is not my function to be the arbiter of the right balance to be struck between all these factors, although a full awareness of the macroeconomic environment and the play of macroeconomic influences must be part of the supervisor's perspective. I would like to concentrate more particularly on the role of the international banking system and the supervisor's concern to ensure that the system is on a sound footing.

There has been some comment recently that the current pressures on the banks will inevitably mean an erosion of prudential standards. I do not accept this view. While taking due account of the need for time for adjustment to which I have just referred, I cannot see that any significant erosion of prudential standards will necessarily have to occur, or will in fact occur, over the next few years. The world's banking system is going to be with us for a lot longer than the particular concerns of the moment, whether in Eastern Europe, Latin America, or closer at home in the domestic portfolios of major banks in a number of industrialised countries. This system has performed invaluable service within the world economy over recent years but if it is to continue to do so it must not be compromised. It must retain the confidence of those who use it and it must retain confidence in itself.

This, however, is not to say that absolute adherence to some fixed supervisory standards at all times is an essential prerequisite for dealing with the present situation. The maintenance of sound prudential standards is, however, a crucial element which needs to be kept firmly in the mind of all concerned in working to achieve a better equilibrium in the world financial scene. Commercial banks individually are their own masters and have to be responsive and sensitive to market forces. They also need to be able to deal with each other on a basis of confidence, believing that the individual units within the system and the system itself is sound. The constraints of the market are a valuable discipline and we turn our face against them at our peril. Also, independence of judgement and action by the commercial banker is something which I cannot believe any country which operates a market economy would wish to give up.

So it will be very important in the period ahead that bankers pay proper attention to the soundness of their own ship. This will include a careful and realistic appraisal of their balance sheet structure, the quality of their assets and the maintenance of good profits. This leads me on to make two further points.

. . . for individual banks, borrowers and the international system . . .

First, how can soundness be reconciled with keeping the system going? Here is a supervisor talking about the need for prudence, including careful attention to new lending propositions and prudent provisioning policies, while elsewhere among the authorities calls are being made to commercial bankers to stay in international business and, indeed, in some cases to increase their commitments in areas where they may have doubts about the soundness—at least in the short term—of doing so. I have to say I do not find this apparent contradiction very troublesome intellectually, and certainly not practically.

Every banker knows there are some situations where, in order to work out a difficult situation with a customer, the balance of arguments points toward some further extension of support, even though the decision to do so may not be without some risk. Bankers' judgements are often not easy and it does not appear to me to fly in the face of reason to suggest that new lending, often with a tinge of doubt attaching to it, may on occasions be the best way of protecting the quality of the existing lending and ensuring its ultimate soundness. All the more so, as the Chairman of the Federal Reserve Board in the United States has made reference, in respect of country lending associated with a programme of adjustment undertaken by a country in connection with IMF assistance. Again the time factor will be an important consideration as these IMF programmes may take some time to bring results.

... and an appropriate sharing of responsibility

The second point involves the particular considerations to be weighed by the banks who consider they are less deeply involved than others in lending to the major international borrowers. It is very important that they should realise that, at least in the same degree as their existing involvement, they have become as much a part of the international banking fabric which has been built up over recent years as their bigger brethren and that in the present situation they have a corresponding share of responsibility. Indeed, it should not be overlooked that many of them, relative to their size, are as exposed as many much larger banks. It may be that some of these smaller banks, in retrospect, would have preferred not to have become involved, but as the Governor remarked a few weeks ago, we are where we are. We have to start from here and now, and not where we might like to have been.

I can understand the smaller banks' argument that they were tempted into the big league market by big banks selling down participations and that they now feel out of their depth. Without the resources for analysis and assessment to back up this business, they claim, they are sensible and justified in withdrawing from it. I understand the argument but it is only part of the story.

Just as the supervisor in his judgements has to have a sense of the wider macroeconomic circumstances, so I believe these smaller banks need to consider very carefully the wider picture, the broader interest of their customers, domestic and international, and the importance of allowing the system collectively to make sensible adjustments over a reasonable timescale. All of these factors, I believe, should lead these banks to recognise that there are good arguments of self-interest for staying in this business. Burdens are best sustained when they are shared. But even the strongest can eventually become overburdened and it will be important in shaping the system for the future, that commercial banks are not asked to do too much and that governments and international agencies should take their proper share of the load.

Many will have a role in achieving a better basis for the system in the future. I would like to consider briefly three areas where the supervisory authorities have a particular interest—the coverage of international supervisory arrangements, sustaining the soundness of banks in the system and improving the information on which bankers and supervisors alike depend to make sound judgements.

The international system needs comprehensive supervision...

It is sometimes said and written that the arrangements by which the supervisory community has sought to ensure that effective supervision operates whenever banks operate internationally are full of holes. I do not believe this to be so. Very substantial progress has been made over recent years towards realising the first objective of the Basle Concordat of 1975, namely, that no international banking activity should escape supervision. This accord was reached initially between the authorities of the Group of Ten countries, Luxembourg and Switzerland who comprise the members of the Supervisors Committee in Basle whose banks conduct very much the greater part of the volume of international banking business. But in addition, since 1975 an increasing number of countries outside the Group of Ten have given their support to achieving this fundamental objective as more and more countries have been drawn into the network of international supervisory co-operation, particularly as a consequence of international conferences of eighty and more countries' supervisory authorities held in London in 1979 and in Washington in 1981.

Now it is true that standards of supervision vary considerably from country to country. But while shortage of resources, financial and human, may limit the scope to execute the supervisory function in a few countries, almost all the countries associated with these international co-operative efforts have in place a sound framework of supervision for the surveillance of international business. There will, of course, inevitably be some international supervisory mishaps. Banks have made and will no doubt continue to make costly mistakes. Malfeasance can never be totally eradicated. But I believe the essential structure is in place within which international banking can operate soundly and confidently. It is misleading to imply that there are large areas of the international banking system which escape supervision. There are no rogue herds of unregulated bankers tramping through international markets. It is true that there are a few, but now only a very few, territories around the world where banking companies are licensed and allowed to operate without any serious efforts to accompany a licence with effective supervision. But such institutions are miniscule in relation to the market as a whole, widely known and recognised for what they are, generally regarded as unacceptable counterparties by the banking community at large, and in no position to undermine the strength of the system as a whole.

... and close contact between supervisors

The essential feature of co-operation between supervisors is that there should always be contact between the different authorities concerned whenever a bank operates across national frontiers. This should ensure that even if national systems vary there can be a clear understanding of the nature and extent of the supervision being exercised by each authority which can be varied sensibly to meet individual circumstances. Banks themselves contribute to this process through their own internal control systems and particularly by increasing resort to the technique of consolidation. This ensures that there is a centralised oversight of an international bank's overall business so that the risk exposure and capital adequacy can be judged in the context of its operations worldwide. The technique of consolidation has, it is true, not yet been fully implemented in all countries, although the members of the Basle Committee have all accepted the principle and are increasingly applying it. But, important as it is, it should not be regarded as some kind of magic formula or panacea for all prudential ills. It is merely one technique, albeit a particularly valuable one, among many in the armoury of bank managements and supervisors.

The absence of effective consolidation and the related circumstances, in the particular recent case of Banco Ambrosiano would, of course, be a matter of concern if the facts of that situation were repeated widely throughout the system. But they are not. There may be, indeed are, some lessons to be learnt from the particular circumstances in that case and some authorities have already reacted to them. There may also be a need to refine somewhat the application of the principle of consolidation to take account of the position of non-banking companies within banking groups. But, as I have said on other occasions, this affair does not, in my view, invalidate the general principles of the Concordat which, as has many times been emphasised, relate to supervisory not to lender of last resort responsibilities. Nor does it represent any major structural weakness in the supervisory arrangements worldwide. The particular circumstances in which the main South American subsidiary bank of the Ambrosiano group had been established, for example, were quite exceptional, as was the structure of the Ambrosiano group as a whole. It is not replicated, as far as I am aware, among any of the major 500 or so banks in the world which are those principally engaged in international business.

Over recent years the supervisory net has spread very widely and become increasingly professional in its application. Some years ago, for example, the offshore centres were felt to be a major Achilles' heel in the system. Improved supervisory procedures in most of those centres and the increased resort to consolidated supervision by parent banks and parent banks' supervisors have significantly modified these earlier views. Indeed, the Basle Committee has developed close and valuable links with all the significant offshore centres who constituted themselves into a formal group two years ago. All this is not to say that no further improvements are possible or that some impediments do not still remain. But here again these lacunae can be overplayed as, for example, with concerns about banking secrecy provisions as a barrier to supervisory co-operation.

In practice, certainly within the Group of Ten, there appears to be little problem about the passing of the aggregated data which is necessary for effective supervision. Details of individual depositors—the most sensitive area—is not normally critical in the supervisory process; and in the area of country risk, as the Basle Committee's work progressed last year it became clear that no member country considered itself effectively barred from monitoring country risk on a consolidated basis because of banking secrecy constraints. Verification of data and rights of inspection may also present some problems but again, either through passing data within banking groups up to the parent entity, or by the use of external auditors, or by the host authority undertaking to pursue enquiries on behalf of the parent authority, ways can usually be found, in practice, of ensuring that supervision can be effectively conducted.

Soundness of individual banks depends on confidence . . .

The second aspect I wish to mention—sustaining the resources of individual banks—has been touched on already when referring to the soundness of each unit in the system. The viability of banks is underpinned by two things. First, confidence in the institution: without confidence, any mismatch of maturities and reliance on historical assumptions about liquidity needs can quickly lead to a bank's undoing. Second, and essential to the first, own funds must be adequate in the judgement of the market. Capital resources are needed for the difficult times and this means that temptations to allow them to become pared to the bone in fair weather must be resisted. But just as liquidity of banks is there to be used when needed, so with capital and reserves when losses occur. Some flexibility may thus be appropriate in judging capital levels in the short term. But while erosion of capital in fair weather is ill-advised, erosion of capital in difficult times can be much more troublesome because in such times it is often less easily reconstituted.

. . . adequate capital and profits

All of this adds emphasis to the need to maintain good levels of profitability and this will make it particularly important to look closely at the margins at which business will be done in the period ahead so that they may reflect more realistically than some margins have done in the recent past the risks attaching to the business. This may not be easy to achieve in a market hungry for good business but I believe banks need to pursue harder their skills in getting the terms right, and with a perspective of not too short a time horizon.

And timely and complete information flows are fundamental

The final aspect which deserves mention is improving information flows. If the terms of lending are to be got right, the analysis and the information on which that analysis is based needs to be as comprehensive and as up to date as possible. Many of you will, I trust, have seen the paper which the Basle Supervisors Committee issued early this year on factors affecting country risk analysis and judgements about banks' country exposure and which stresses this point particularly. Bankers worth their salt are not likely to lend to commercial concerns without looking at the resources, the cash flow and the markets of those businesses. So it must be for lending to countries, and the supervisors recognise that they have at least some responsibility for ensuring that official sources make their full contribution to the information flows. A lot has been done in recent years, particularly by the Bank for International Settlements, to improve country indebtedness data but improvements are still possible, particularly in the timeliness of information for which national authorities and the banks themselves hold the key.

One of the particularly difficult areas is data on short-term indebtedness: it is very important to be able to observe changes in financing patterns and growth in short-term borrowings. Another area where improvements are needed is the provision of data by borrowing countries themselves and here the banks may need to press harder for the necessary data. On both these points the recent discussions between bankers in the context of what has become known as Ditchley II have been a useful initiative.

The best kind of banking relationships are where the banker is close to his customer and the ideas under discussion for improving the information from the major international borrowers, with some modest centralised capacity to assist this process, should be useful. It will be particularly valuable if it enables the many smaller banks operating in international markets to keep more abreast of the situation and to feel more confident that this is a business in which they can sensibly continue to play a part. At the same time I would be hopeful that such an organisation might be able to make a contribution to the problem of adequate data on short-term financing by improved access to really up-to-date information. Such information should enable changes in financing patterns to become quickly evident—hopefully more quickly than at present—for the benefit of all in the market. The proposed Institute will have a difficult and a delicate task, and will need wide support and high quality personnel, but the present and continuing importance of bank financing in international markets make it desirable that this initiative should be sustained.

These are the foundations of a strong banking system

So the international banking system needs these three elements: first, confidence in the supervisory superstructure—its professionalism and its coverage; second, confidence that banking institutions in different countries are soundly based and that the strength of those institutions—on which the integrity of the system depends—is not undermined by prudential laxity or national profligacy; and third, the best possible access to the data about businesses, economies, markets and risks on which sound, broad-based management judgements depend. With these in full measure the system should have the confidence to be flexible, the ability to withstand sudden shocks and the capacity to endure even prolonged strains. Also, with these elements in place, the complex interrelationships in the international marketplace will prove a strength, as I believe they have to date, and not a source of weakness. We will need to continue to work hard on performance in all these three areas, but if they are well sustained the international banking system, appropriately supported by the actions of governments and international agencies, will continue its inestimable service to the world economy.